FILE COPY

Office Supreme Court, U. S.
FILED
APR 10 1931
CHARLES ELMORE CROPLEY
CLERK

Nos. 521, 522

In the Supreme Court of the United States

OCTOBER TERM, 1930

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

EDITH ANDREWS LOGAN

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JULIA ANDREWS BRUCE

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statute and regulations involved	3
Statement	3
Specification of errors	6
Summary of argument	7
Argument:	
Preliminary statement	9
I. The fair market value as of March 11, 1916, of the purchased interests was sufficiently established	10
II. The annual receipts from the contract constituted gross income and a sufficient allowance for exhaustion has been made	21
Conclusion	33
Appendix A (statutes and regulations involved)	34
Appendix B (order of C. C. A. 6th in *Shaw* v. *Commissioner of Internal Revenue*	40

CITATIONS

Cases:	
Allen v. *Brandeis*, 29 F. (2d) 363	28
Bedell v. *Commissioner of Internal Revenue*, 30 F. (2d) 622	13
Bishoff v. *Commissioner of Internal Revenue*, 27 F. (2d) 91	13
Chicago Ry. Equipment Co. v. *Blair*, 20 F. (2d) 10	13
Doyle v. *Mitchell Brothers Co.*, 247 U. S. 179	31
Eldredge v. *United States*, 31 F. (2d) 924	27–28
Goldfield Consol. Mines Co. v. *Scott*, 247 U. S. 126	22
Hitchcock v. *Commissioner*, 44 F. (2d) 756	10–12, 20, 25–27
Irwin v. *Gavit*, 268 U. S. 161	12, 20
Kentucky Tobacco Products Co. v. *Lucas*, 5 F. (2d) 723	22
Klein, Florence L., v. *Commissioner*, 6 B. T. A. 617	29–30
Kosmerl v. *Commissioner of Internal Revenue*, 25 F. (2d) 87	30
Lynch v. *Alworth-Stephens Co.*, 267 U. S. 364	22
New Creek Co. v. *Lederer*, 295 Fed. 433, certiorari denied, 265 U. S. 581	22
Newman v. *Commissioner of Internal Revenue*, 41 F. (2d) 743, certiorari denied, 282 U. S. xiii	12

Cases—Continued. Page

Nichols v. *United States*, 64 C. Cls. 241, certiorari denied, 277 U. S. 584 32
Peck v. *Kinney*, 143 Fed. 76 23
People v. *Lynch* (N. Y. Court of Appeals), not yet reported, but may be found in United States Daily, January 12, 1931, p. 9 29
Platt v. *Bowers*, 13 F. (2d) 951 30
Reinecke v. *Spalding*, 280 U. S. 227 13
Rosenberger v. *McCaughn*, 25 F. (2d) 699, certiorari denied, 278 U. S. 604 30–31
Roxburghe, Mary, v. *United States*, 64 Ct. Cls. 223, certiorari denied, 278 U. S. 598 22
Ruth Iron Co. v. *Commissioner of Internal Revenue*, 26 F. (2d) 30 30
Shaw v. *Commissioner of Internal Revenue*, C. C. A, 6th, decided Nov. 5, 1930 ..... 25, 40
Stanton v. *Baltic Mining Co.*, 240 U. S. 103 ..... 22, 32
Stone v. *United States*, 164 U. S. 380 18
United States v. *Supplee-Biddle Co.*, 265 U. S. 189 20
United States v. *Bolster*, 26 F. (2d) 760 28
Von Baumbach v. *Sargent Land Co.*, 242 U. S. 503 22
Warner v. *Walsh*, 15 F. (2d) 367 28

Statutes:

Revenue Act of 1918, c. 18, 40 Stat. 1057—
Section 202 34
Section 210 34
Section 211 34
Section 212 34–35
Section 213 35
Section 214 35
Revenue Act of 1926, c. 27, Sec. 1003 (b), 44 Stat. 9, 110 (U. S. C. App., Title 26, Sec. 1226) 13

Miscellaneous:

Sol. Op. 160, III–2 C. B. 60 23
Treasury Regulations 45 (1920 ed.), as amended by Treasury Decision 3206 (relative to the Revenue Act of 1918)—
Article 201 36–37
Article 206 37–38
Article 210 38
Article 1564 39

In the Supreme Court of the United States

OCTOBER TERM, 1930

No. 521

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

EDITH ANDREWS LOGAN

No. 522

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

JULIA ANDREWS BRUCE

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR THE PETITIONER

OPINIONS BELOW

The opinion of the United States Circuit Court of Appeals in No. 522 (R. 87–88) is reported in 42 F. (2d) 197, and the opinion in No. 521 (R. 94–99)

is reported in 42 F. (2d) 193. The findings of fact and the opinion of the Board of Tax Appeals (R. 15–32)[1] are reported in 12 B. T. A. 586.

JURISDICTION

The judgments to be reviewed were entered on May 26, 1930. (No. 521, R. 100–No. 522, R. 88.) On August 27, 1930, the time for filing petitions for certiorari was extended to October 21, 1930. (No. 521, R. 100–No. 522, R. 89.) Petitions for certiorari were filed October 21, 1930, and were granted on December 1, 1930. (No. 521, R. 101–No. 522, R. 91.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Respondents acquired certain interests in a contract by virtue of which they received annually certain payments measured by the number of tons of iron ore delivered from a certain mine. The question presented is whether the payments received under the contract are to be regarded in the earlier years as entirely a tax-free recovery of capital, as held by the Circuit Court of Appeals, or whether each payment is to be regarded as partly a return of capital and partly the receipt of income.

---

[1] Unless otherwise stated, all record references relate to No. 521.

STATUTE AND REGULATIONS INVOLVED

These will be found in Appendix A.

STATEMENT

These cases reached the Circuit Court of Appeals on petitions to review orders of the Board of Tax Appeals (No. 521, R. 35–No. 522, R. 27), determining deficiencies against respondent in No. 521 for the years 1918, 1919, and 1920, and against the respondent in No. 522 for the years 1918 and 1919.

The facts as found by the Board (R. 15–20) are in substance as follows:

Prior to March 1, 1913, and until March 11, 1916, the respondents owned certain shares of the stock of the Andrews & Hitchcock Iron Company, which company held a 12% stock interest in the Mahoning Ore & Steel Company. The latter company controlled, by a lease for a long term of years, an iron-ore mine. (R. 15.) The Mahoning Company was an operating company, and, pursuant to contract provisions, distributed the ore which it mined only to its stockholders, who were steel manufacturers. (R. 16, 49–51.)

On March 11, 1916, the Youngstown Sheet & Tube Company purchased all the outstanding capital stock of the Andrews & Hitchcock Company, thus acquiring the 12% stock interest in the Mahoning Company and the right to a percentage of the ore mined by it. (R. 15.) The Youngstown

Company paid $2,200,000 in cash for the Andrews & Hitchcock stock, and in addition, as the balance of the purchase price, contracted to pay to a depositary for the benefit of the former stockholders of the latter company sixty cents per ton for each and every ton of iron ore which the Youngstown Company might thereafter become entitled to receive from the Mahoning Company. (R. 16.) Payments were to be made annually under the contract and the stock in the Mahoning Company was to be deposited as collateral security. (R. 46–49.) Respondents thus acquired rights to payments under this contract in proportion to their holdings in the stock of the Andrews & Hitchcock Company. Mrs. Logan acquired a 250/4000 interest and Mrs. Bruce acquired a 350/4000 interest. (R. 47.)

In 1917 the mother of the two respondents died, and each acquired by bequest an additional 550/4000 interest in the contract. (R. 18, 44.)

The fair market value of the Youngstown contract on March 11, 1916, was found by the Commissioner to be $1,942,111.46. This was based upon an estimate that the ore reserves at the Mahoning mine amounted to 82,858,535 tons; that all such ore would be mined; that 12 per cent (or 9,942,564.2 tons) would be delivered to the Youngstown Company. (R. 20.) The total amount to be received by all the vendors of stock would

then be $5,965,814.52 at the rate of 60 cents per ton. The Commissioner's figure for the fair market value on March 11, 1916, was the then worth of $5,965,814.52, upon the assumption that the amount was to be received in equal annual installments during 45 years, discounted at 6 per cent, with a provision for a sinking fund at 4 per cent. For lack of evidence to the contrary this value was approved by the Board. (R. 28.) The value of the 550/4000 interest which each acquired by bequest was fixed at $277,164.50 for purposes of Federal estate tax at the time of the mother's death. (R. 18.)

During the years here involved the Youngstown Company made payments in accordance with the terms of the contract, and respondents respectively received sums proportionate to the interests in the contract which they acquired by exchange of property and by bequest. (R. 17–18.)

The Board held that respondents' receipts from the contract, during the years in question, represented "gross income"; that respondents should be allowed to deduct from said gross income a reasonable allowance for exhaustion of their contract interests; and that the balance of the receipts should be regarded as taxable income. (R. 28–29.)

The Circuit Court of Appeals reversed the Board's decision. It held (R. 99) that no part of the receipts during the years in question consti-

tuted taxable income; and that no income would be received until respondents had first recovered—(1) As regards their interests in the contract acquired by exchange of property, the March 1, 1913, value of the property exchanged, and (2) as regards their inherited interests the value of those interests at the time of their mother's death.

SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred:

1. In holding that the contract right to receive annual payments in the future had no fair market value, and that the sale of stock by which the contract was acquired was therefore not a closed transaction.

2. In holding that the contract did not have a fair market value of $1,942,111.46 on March 11, 1916, as determined by the Commissioner and approved by the Board of Tax Appeals.

3. In holding that the difference between the $2,200,000 in cash and the March 1, 1913, value of the stock must be returned through the payments under the contract before there could be any income from the contract right acquired through the sale of stock.

4. In failing to recognize that the interest acquired in the contract through inheritance presented a question not controlled by the determination that the interest acquired through sale of stock

had no fair market value, and in applying the same reasoning to both interests. There is no finding that the inherited interest was not capable of being capitalized anew. On the contrary, the opinion below recognizes that it had a capital value.

5. In holding that the payments received by respondents under their contract rights were not taxable in any part as income during the years 1918, 1919, and 1920.

SUMMARY OF ARGUMENT

Respondents sold corporate stock, receiving therefor part cash and an interest in a contract providing for a payment of 60 cents on each ton of ore which the purchaser became entitled to take from the Mahoning mine. Respondents later acquired additional interests in the same contract by bequest from their mother.

The Commissioner determined that the contract had a fair market value and accordingly treated the sale of the stock as a closed transaction and valued the contract rights as of the time of their receipt, which he used as the basis for apportioning the annual receipts from the contract between income and capital.

The court below held that the fair market value of the contract had not been established, that the sale of respondents' stock was not a closed transaction, and that no part of the annual receipts from the contract was income, because respondents had

not yet received the March 1, 1913, value of their stock or the value of the inherited interests in the contract at the time of their mother's death.

1. Whether property has a fair market value is a question of fact. The finding of the Board that the contract had fair market value was supported by substantial evidence and should have been accepted by the court below, as it was by the Circuit Court of Appeals for the Sixth Circuit in a group of cases presenting the same question with respect to the same transaction.

2. The annual receipts from the contract were inherently income by nature, and it is not entirely clear that respondents were entitled to any of the statutory allowances for depletion or exhaustion. However, an allowance was made by the Board for the exhaustion of the contract, and for present purposes we merely contend that it is sufficient. The Circuit Court of Appeals for the Sixth Circuit approved the apportionment between income and capital, and its decision is in direct conflict with the decision of the court below. The requirement that capital must all be returned tax free before there is any income is limited to cases of sales, and in several decisions the courts have held that where the period of payment is extended over several years it is more logical to say there is some income involved in each payment.

In so far as the annual payments received by respondents were attributable to the inherited in-

terests, the question is controlled by *Irwin* v. *Gavit*, 268 U. S. 161. The decision of the court below sanctions a rule in conflict with that decision. Moreover, the decision below is not supported by its reasoning, which is solely applicable to the purchased interests in the contract.

ARGUMENT

PRELIMINARY STATEMENT

The property which produced the income in these cases was a contract providing for a payment of 60 cents on each ton of ore which the Youngstown Company became entitled to take from the Mahoning mine. The payments received in the taxable years were segregated by the Commissioner into part income and part return of capital. The Board of Tax Appeals held that the annual receipts should be included in gross income in their entirety but that a deduction should be allowed for the exhaustion of the contract under Section 214 (a) (8) of the Revenue Act of 1918, applying the same method of calculation as is used for determining depletion of mines. Since the net result was the same as the Commissioner's determination (R. 30), the Board sustained the Commissioner.

The Circuit Court of Appeals held, in effect, that the fair market value of respondents' interests in the contract of 1916 had not been established, that this contract did not represent a closed transaction, that the basis for computation was the March

1, 1913, value of the shares owned by the respondents and the value at the time of the mother's death of the inherited interests in the contract, and that no taxable income arose until the whole of those values were returned to respondents.

I

THE FAIR MARKET VALUE AS OF MARCH 11, 1916, OF THE PURCHASED INTERESTS WAS SUFFICIENTLY ESTABLISHED

The Commissioner determined that when the respondents sold their stock in 1916 the value of the interests acquired by them in the contract plus the cash they received was more than the cost but less than the March 1, 1913, value of their stock and that hence the transaction resulted in neither gain nor loss. (R. 57, 95.) The court below held that the contract interests had no ascertainable fair market value when acquired by respondents in 1916 (R. 97) and that therefore the exchange did not constitute a closed transaction. Upon this theory it held that there is no taxable income until there has been a return of the March 1, 1913, value of respondents' stock interests in the Andrews & Hitchcock Company, and of the value as at the mother's death of the inherited interests in the contract. (R. 99.)

The Circuit Court of Appeals for the Sixth Circuit, considering a precisely similar question arising out of the same contract, in *Hitchcock* v. *Com-*

missioner of Internal Revenue, 44 F. (2d) 756, took a contrary view and said (p. 758):

> It is insisted, though, that the proofs show that the contract was not capable of valuation in money because of the changing conditions in the steel industry, the dependency of the Youngstown Company's obligations upon the policies of the companies owning the controlling stock in the Mahoning mines, and the many uncertainties that arise in the operation of mining properties. Here again the finding of the commissioner is to be treated as prima facie correct (*Wickwire* v. *Reinecke,* 275 U. S. 101, 48 S. Ct. 43, 72 L. Ed. 184; *Austin Co.* v. *Commissioner,* 35 F. (2d) 910 (6 C. C. A.)); and upon a consideration of the evidence we do not feel justified in overruling it. It was not necessary that the contract should be for sale or that there should be a known buyer for it before it could have a market value. *Chicago Railway Equipment Co.* v. *Blair* (C. C. A.) 20 F. (2d) 10. It is true that it was held in both *Bourn* v. *McLaughlin* (D. C.) 19 F. (2d) 148, and *Tsivoglou* v. *United States* (D. C.) 27 F. (2d) 564, that certain properties received in exchange for others had no realizable value in money's worth, and hence there was no taxable gain on the exchange. Those cases, however, turned on their special facts, and dealt with values for the purpose of determining losses or gains on the property given in exchange. In this case the value was fixed, not to determine gain or loss on the

stock but to apportion earnings from the contract to capital and gain. The necessity for ascertaining the value of capital consumed in producing income is obvious. It is a necessity that frequently arises and is clearly contemplated in the statutory provisions authorizing allowances for obsolescence, depletion, and exhaustion. Revenue Act 1918, § 214 (a) (8) and (10), 40 Stat. 1067. The best methods that can be used are often lacking in demonstrable exactness. See *United States* v. *Ludey,* 274 U. S. 295, 47 S. Ct. 608, 71 L. Ed. 1054. The one used in this instance received the approval of this court in the *Eldredge Case.* We think it was fair, and we are also of opinion that the commissioner properly apportioned the receipts between capital and income.

The decision in the *Hitchcock case* is in harmony with the evident purpose of Congress to reach all income (see *Irwin* v. *Gavit,* 268 U. S. 161, 166) and to tax it as soon as received. The shifting of income from one year to another is to be avoided. *Newman* v. *Commissioner of Internal Revenue* (C. C. A. 10th), 41 F. (2d) 743, certiorari denied, 282 U. S. xiii.

The statute provides that when property is received in an exchange it shall be treated as the equivalent of cash to the extent of its fair market value. Section 202 (b) of the Revenue Act of 1918, *infra.* Fair market value may be said to mean the price at which a seller, willing to sell at a fair price, and a buyer, willing to buy at a fair

price, both having reasonable knowledge of the facts, will conclude a bargain. Cf. *Chicago Ry. Equipment Co.* v. *Blair* (C. C. A. 7th), 20 F. (2d) 10, 13.

The question whether property has a fair market value is one of fact to be determined in each case in the light of all the surrounding circumstances. The Board of Tax Appeals found that the contract had a determinable fair market value when received by respondents in 1916, and that there was no evidence showing that the value determined by the Commissioner was erroneous. (R. 24.) This is in accord with the rule that the determination of the Commissioner is *prima facie* correct and that taxpayers have the burden of establishing that it is erroneous. *Reinecke* v. *Spalding,* 280 U. S. 227. Moreover, the Board of Tax Appeals is a fact-finding body and upon review of its decision an appellate court should not reject the Board's findings unless wholly unsupported by the evidence. *Bishoff* v. *Commissioner of Internal Revenue* (C. C. A. 3d), 27 F. (2) 91, 92. The court below recognized this rule (*Bedell* v. *Commissioner of Internal Revenue* (C. C. A. 2d), 30 F. (2d) 622, 625), and it is well settled that appellate review of decisions of the Board extends only to questions of law. This is in accord with the statute, which provides that the courts shall have power to reverse a decision of the Board if it is not in accordance with law. (Section 1003 (b) of the Revenue Act of 1926, c. 27, 44 Stat. 9.)

We therefore submit that the narrow question of law with respect to whether the contract was the equivalent of cash is: Was there substantial evidence to support the findings of the Board? A review of the evidence shows the following:

The property to be appraised in the cases at bar is the contract providing for net payment of 60 cents on each and every ton of ore which the Youngstown Company may become entitled to take from the Mahoning mine. The obligation to make such payments was absolute and was secured both by the credit of the Youngstown Company and by the 360 shares of stock of the Mahoning Ore and Steel Company. It follows, therefore, that if the tonnage and production of the Mahoning mine can be gauged with reasonable accuracy the determination of value for the contract in question is merely a matter of mathematical calculation.

The Mahoning mine is one of the leading and largest iron ore mines in the United States. (R. 84.) Its location and capacity are described by respondents' witness Agnew. (R. 73, 78.) Estimates of the ore content of the properties had been made by the Minnesota Tax Commission, and after making drillings to test their accuracy the Mahoning Company found the estimates to be conservative. (R. 77.) The report of the Minnesota Tax Commission shows that the ore content of the property could be calculated with unusual accuracy. (R. 85.) The Mahoning Company itself made es-

timates of the ore tonnage in connection with fixing its depletion rates. (R. 75, 82.) The record shows that the Mahoning Company had estimated the average annual production of part of the property for a period of 25 years into the future (R. 75, 81), that the conduct of the mining operation required estimates of from 10 to 12 years ahead, and that it was practicable to forecast the requirements of ore for at least 20 years in advance (R. 80). It was testified that the Commissioner's estimate of a probable life of 45 years was very accurate. (R. 89.)

The determination by the directors of the Mahoning Company of the annual production (R. 16) does not make for uncertainty. It is necessary to the laying of plans for the operating season and is not peculiar to this mine, save in that it also serves to apprise the furnace companies of the quantity of ore that will be shipped to them during the season. The heavy local tax burden (R. 19) will no doubt insure the removal of this high-grade ore (R. 84) as fast as the market will permit.

This property was held for the use and benefit of five steel manufacturing companies (R. 50), and was operated to meet their needs (R. 51). Property of this nature is not held as an investment. It is the source of supply for manufacturing corporations and is ordinarily not for sale. The true value of such a property could only be determined after full development (R. 65), and sales are usually made for only part of the consideration in

cash (R. 65, 66, 67, 86). It is true that there was no regular market for the sale of such contracts (R. 62), but respondents' witnesses did not say that no market could have been found (R. 63). Their testimony was merely that they knew of no sales by which the fair market value could be determined, no general market for contracts of that character, and no established or current market price. (R. 62.)

Respondents' witness Putnam testified (R. 65):

> Now, I do not mean by that that it has no value, and I do not mean by that that you can not arrive at some value for it; but so far as the cash sale value goes, customarily those contracts and interests in iron ore properties are not dealt in in that way.

While the elements which determine the value of this contract were not definitely fixed (R. 64), there is no evidence that the contract was not salable. In view of the inherent value of the property, such evidence, if given, would not have been convincing. While the value of the contract may have been subject to uncertainties, there is no evidence sufficient to overcome the Board's finding. The Board reviewed the evidence carefully and concluded as follows (R. 23–24):

> The contract which the stockholders of the Andrews & Hitchcock Iron Co. had with the Youngstown Sheet & Tube Co. was that they should receive 60 cents per ton upon their

12 per cent interest in the ore mined from the Mahoning mine. The important question in the case is as to whether that contract had a fair market value as of March 11, 1916. The petitioners contend that they could not have gotten a fair market value for their interests in the contract if they had attempted to sell them. Witnesses for the petitioners believed that the true value of the interest of each of the petitioners was much in excess of what each could have sold it for. This question of belief does not, however, in our opinion satisfactorily establish that the interests had no fair market value. In 1916 it could be foreseen that each of the petitioners would receive considerable amounts of money under the contract during the years immediately succeeding 1916. It is hardly probable that persons conversant with the contract would not have given something for the interests of the several petitioners therein. Statements that the contract had no value because in the opinion of certain witnesses the interests of petitioners therein could not have been sold at their full market value is not satisfactory evidence that they did not have a fair market value.

The Committee on Appeals and Review of the Treasury Department reached the same conclusion. (R. 59.)

It was not necessary for the Board of Tax Appeals to discredit the witnesses in order to justify its conclusion that respondents' interests in this

contract had a fair market value. "To say that the testimony is not satisfactory is more polite and less offensive, and at the same time equally sufficient." *Stone* v. *United States,* 164 U. S. 380, 382.

It is true that the court below differed with the Board with respect to the effect of the testimony (R. 97), but we submit that the elements of uncertainty which the Circuit Court of Appeals thought indicated impossibility of valuing the contract easily merely tended to show that its exact value could not be fixed. This did not render it impossible for the Board to put a value upon it, based upon the evidence offered to show its value, nor do the largely imaginary elements of uncertainty, emphasized by the court below, indicate that the determination of the Board was wrong. The holders of this contract were assured of 60 cents per ton upon 12 per cent of the total ore reserves of the Mahoning Company and payments were guaranteed by collateral security. There is no basis in the record for the suggestion of the court below that the contract might be abrogated or changed. Its performance by the Youngstown Company was adequately assured. There was a published production record from the year 1900. (R. 77.) The average production for the three years preceding 1916 was slightly less than 2,000,000 tons. (R. 89.) The production for the year 1915 was 2,311,940 tons. (R. 46.) This production came from only 240 acres out of the total of 1,000 acres leased by the

Mahoning Company. (R. 83.) Judging from the experience of production over this long period, and in the absence of proof of changed conditions which might suggest the probability of a change in rate of production in the future, it was possible to forecast with a fair degree of accuracy the productive life of the mine. The court below emphasized the fact that production was to be determined by the board of directors of the Mahoning Company, but there was no proof to show that they would capriciously order a departure from past rates of production nor that there was any reason for them to do so. The uncertainties were reduced to a minimum and can not reasonably be said to render it impossible to value the contract. We think it is not to be doubted that this contract, which was yielding its owners large sums annually, had market value as well as intrinsic value.

The calculation which would establish "fair" market value could be made as readily by the Commissioner of Internal Revenue as by a prospective purchaser. The fair market value of the contract was in fact determined in 1917 when respondents' mother died, and that value was used for Federal estate-tax purposes. It was equally possible to calculate it in 1916, and the Board's finding that this contract had a fair market value in 1916, based upon substantial evidence, should have been accepted by the court below.

The court below gave no separate consideration to the inherited interests in the contract. The portion of returns from those interests which represented income was taxable in the same way as were the returns from the purchased interests. See *Irwin* v. *Gavit*, 268 U. S. 161. No question of value can well arise with respect to the interests inherited, for their value had to be, and was, determined at the time of the mother's death in 1917.

An allowance was made for the exhaustion of the contract, so that the capital value of the right to receive the income will be ultimately returned tax free, and no double taxation can arise from the fact that the value of this right was included in the gross estate of respondent's mother. Cf. *United States* v. *Supplee-Biddle Co.*, 265 U. S. 189, 196.

It is true that the Circuit Court of Appeals for the Sixth Circuit in the *Hitchcock case* gave no separate consideration to the inherited interests in the contract. In our view there is no difference in principle between the rule to be applied in determining the taxability of income derived from the inherited interests and the purchased interests if the sale of the stock is treated as a closed transaction. The Circuit Court of Appeals for the Sixth Circuit adopted this view, and treating the sale as a closed transaction had no occasion to consider the inherited interests separately. The court below held that the sale was not a closed transaction

and made no distinction in its treatment of interests acquired upon the sale and by inheritance thereafter. If its reasoning could prevail in regard to the sale, such conclusion can have no bearing upon interests subsequently acquired by inheritance.

It is clear that the contract had a fair market value on March 11, 1916, and there was no basis for the lower court's requirement that value on March 1, 1913, should be the measure of capital to be restored.

II

THE ANNUAL RECEIPTS FROM THE CONTRACT CONSTITUTED GROSS INCOME AND A SUFFICIENT ALLOWANCE FOR EXHAUSTION HAS BEEN MADE

There remains to be considered whether the payments received under the contract during the years involved were wholly free from tax. The court below held that no taxable income arose until the full amount of the original values had been returned. The Commissioner apportioned the receipts from the contract between income and capital return. The Board of Tax Appeals held them to be gross income but allowed a deduction for exhaustion of the contract under Section 214 (a) (8) of the Revenue Act of 1918 and applied the depletion method for determining the exhaustion.

It is not entirely clear that any deductions should have been allowed in these cases. It has long been settled that when no sale is involved annual receipts

which represent the earnings of property are taxable in their entirety unless Congress makes an allowance for exhaustion of the property. *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364; *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503; *Goldfield Consol. Mines Co.* v. *Scott*, 247 U. S. 126; *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103. Whether any annual allowance shall be made is a matter clearly within the province of Congress. *New Creek Co.* v. *Lederer* (C. C. A. 3d), 295 Fed. 433, certiorari denied, 265 U. S. 581; *Kentucky Tobacco Products Co.* v. *Lucas*, 5 F. (2d) 723.

Section 214 (a) (10) of the Revenue Act of 1918, *infra*, makes an allowance for the depletion of mines, and this Court has held that such an allowance may be "made to everyone whose *property right and interest therein* has been depleted." (Italics ours.) *Lynch* v. *Alworth-Stephens Co.*, *supra*, p. 370. It is true that the mine to which the contract here involved related was being depleted by the extraction of the ore, but respondents had no interest in the mine nor such a relation to the mine as would entitle them to the statutory allowance. Cf. *Roxburghe* v. *United States*, 64 C. Cls. 223, certiorari denied, 278 U. S. 598.

Section 214 (a) (8) of the statute makes an allowance for the exhaustion of property used in the trade or business, and the Board of Tax Appeals held that respondents were entitled to an allowance under that section. (R. 28.) Certainly this

was a liberal construction of the statute, for it seems to us that respondents could not fairly be said to be engaged in any trade or business in which their interests in the contract were used.

Section 213 (b) (2) exempts from taxation the amount received by the insured as a return of premiums paid by him under annuity contracts. The essential element of an annuity is the certainty of an amount to be paid periodically at a certain rate per annum or in a certain aggregate annual amount. *Peck* v. *Kinney* (C. C. A. 2nd), 143 Fed. 76, 80. Such certainty is lacking here and thus Section 213 (b) (2) is not applicable. And in no event could that part of the payments attributable to the inherited interests be construed as a return of premiums paid by respondents.[2]

However, a deduction was allowed by the Commissioner and the Board of Tax Appeals in these cases and for present purposes we merely contend that it is sufficient and that respondents have no right to demand that it be increased to such an extent as to render all payments to them under this contract tax free for an indefinite number of years when that would introduce a necessarily artificial interpretation of the nature of the payments.

Since the total amount to be received from the Youngstown Company by all the vendors of stock was $5,965,814.52 (according to the Commission-

[2] For a discussion of the taxability of annuities see Sol. Op. 160, III-2 C. B. 60.

er's computation), while the present worth on March 11, 1916 (the total amount of capital to be restored for all vendors, a proportion of which only having to be restored for each respondent) was but $1,942,111.46, each cash payment to each of the respondents would necessarily be approximately 1/45 of her proportionate interest in $5,965,814.52. Each payment would, therefore, include some profit on her share of the original capitalization of this contract.

It can not be said that the first annual payments under the contract here involved were different in character from the payments to be made in later years. Nevertheless, under the decision below, it is necessary to treat the payments in the earlier years as wholly a return of capital and the payments in the later years as wholly income. This incongruous result is not required by any established principle and seems a wholly arbitrary classification. The principle of capital recovery approved by the court in these cases might result in no taxable income ever being derived from the contract. The decision necessarily postpones the receipt of income until later years and if respondents should die in the meantime the rights under the contract would be recapitalized for their heirs, just as was done on the death of respondents' mother. (R. 18.) Thus the receipt of taxable income from this property would be still further postponed. Accordingly, it is possible that re-

spondents' interests in the contract might pass by inheritance from one person to another and that no tax on the annual payments would ever become due.

On the question of whether payments on the contract are to be regarded as subject to apportionment between capital and income, the decision of the court below is in direct conflict with that of the Circuit Court of Appeals for the Sixth Circuit in *Hitchcock* v. *Commissioner*, 44 F. (2d) 756.[3] In affirming the decision of the Board in the *Hitchcock case* the Circuit Court of Appeals for the Sixth Circuit said (pp. 757–758):

> "By the transaction of March 11, 1916, the petitioner received, as part consideration for his stock, an income-producing contract. That contract, in our opinion, is indistinguishable in its legal aspects from the con-

[3] The *Hitchcock case* was one of a group of four cases involving stockholders of the Andrews & Hitchcock Company other than respondents. These cases were all heard together in the Board of Tax Appeals (R. 13), and included the *Appeal of Carrie L. Shaw, Executrix of the estate of John Shaw, deceased*. The findings of the Board show that John Shaw acquired an interest in the contract involved in these cases by way of gift. (R. 17.) The cases of all four stockholders were heard on a consolidated record in the *Hitchcock case* and the decision of the Board of Tax Appeals was affirmed in the *Shaw case* on the authority of the *Hitchcock case*. A copy of the unreported order in the *Shaw case* is attached to this brief as Appendix B. Thus, it appears that the question as presented to each of the Circuit Courts of Appeals was based on interests in the contract acquired both by purchase and by inheritance or gift.

tract involved in *Eldredge* v. *United States* (C. C. A.), 31 F. (2d) 924, where the taxpayer assigned an option for a lease in consideration of a promise to pay two and a half cents per ton of coal mined if the assignee elected to take the lease. This court held in that case that the contract right to the two and a half cents a ton of coal mined was property having an ascertainable market value within the meaning of the taxing statutes, and that the payments made thereon were in part return of capital and part income. We are aware, of course, of the inconsistency between that decision and the decision of the Second Circuit Court of Appeals in *Logan* v. *Commissioner,* 42 F. (2d) 193, where it was held that the payments made to certain former stockholders of the Andrews Company on the contract here involved were to be treated as capital payments until the entire capital value (it would seem the March 1, 1913, value of the Andrews Company stock) was paid in full. The *Logan Case* was decided, as stated by the court, upon the principle announced in the earlier decision of the same court in *Warner* v. *Walsh,* 15 F. (2d) 367. We had *Warner* v. *Walsh* under consideration in the *Eldredge Case,* and for the reasons given in the opinion in that case did not deem it controlling. Neither do we deem it applicable in the present case, for we think the fairer method of treating returns from a contract such as this is to apportion them to capital

> and income in the proportion that the total capital to be recovered bears to the total anticipated receipts. To follow the *Logan Case* in this case would require an abandonment of that view and the overruling of the *Eldredge Case*. This we would do if we thought the latter case wrong, but upon a reconsideration of it in the light of the arguments now made, we still believe that it was rightly decided and in the present circumstances is controlling. Compare *Kosmerl* v. *Commissioner* (C. C. A.) 25 F. (2d) 87; *Ruth Iron Co.* v. *Commissioner* (C. C. A.) 26 F. (2d) 30, and *Reinecke* v. *Spalding*, 280 U. S. 227, 50 S. Ct. 96, 74 L. Ed. 385.

In the case of *Eldredge* v. *United States* (C. C. A. 6th), 31 F. (2d) 924, relied on as an authority in the *Hitchcock case*, the taxpayer owned a contract which produced a payment of two and one-half cents on each ton of coal mined by the corporation and the court was called upon to decide what portion of the payments represented taxable income. The court said (p. 928):

> It does not, however, follow, as appellants contend, that nothing is taxable until appellants have received payments to an aggregate amount exceeding the 1913 capital value. The statement that a taxpayer is entitled to return of capital means nothing more than that, by the time he has received all the money coming to him in a transaction, he must have been allowed to deduct his full capital; it does not necessarily mean that no

> tax is to be imposed until the entire capital shall have been received.

The words quoted were written by the same judge who wrote the earlier opinion in *Warner* v. *Walsh* (C. C. A. 2d), 15 F. (2d) 367, relied by the court below in the instant cases. With reference to the decision in *Warner* v. *Walsh*, he explained that the decision reflected the then prevailing departmental practice which was merely accepted without argument. After a careful examination of applicable decisions, the court concluded as follows in the *Eldredge case* (p. 929):

> In our judgment, the rule properly applicable in the circumstances of the instant case is that income tax is due upon so much of each annual payment as represents approximately a proportionate amount of the profit on the whole transaction, looked at from the standpoint of March 1, 1913. The first payments are clearly not wholly a return of cost. While for practical reasons, it may be desirable so to deal with them if there be a very high degree of uncertainty as to what, if any minimum profit will result from the transaction, as in most cases of liquidating dividends, this is not true in respect to the case.

Warner v. *Walsh, supra,* as well as *United States* v. *Bolster* (C. C. A. 1st), 26 F. (2d) 760, and *Allen* v. *Brandeis* (C. C. A. 8th), 29 F. (2d) 363, all of which were relied on by the court below, have been recently examined by the New York Court of Appeals, which expressly refused to follow them.

People v. *Lynch*, not yet reported, but may be found in United States Daily, January 12, 1931, page 9. The New York law involved in that case was identical with the Federal revenue law. In that case the court said:

> That the income from this trust estate is not exempt as a gift or bequest, see *Irwin* v. *Gavit*, 268 U. S. 161, which strongly indicates that income remains income, under the Federal income tax act, until it clearly appears to be a return of a capital payment, or the payment of a bequest in installments. The same thought follows in *Jones* v. *Commrs. of Inland Revenue* (1 K. B. Div. (1920) page 711).

In *Florence L. Klein* v. *Commissioner*, 6 B. T. A. 617, the Board of Tax Appeals expressly rejected that part of *Warner* v. *Walsh* which dealt with the manner in which deductions were to be made, and held that so much of the first and each succeeding installment as represents the cost or the March 1, 1913, value is to be treated as a return of capital tax free and the remainder is to be treated as taxable income. In its opinion the Board said (p. 622):

> The statutes provide neither that the first payments are all income nor that they are all return of cost; but they indicate rather that each payment is partly one and partly the other, and that the income part is all that is to be included in gross income. This is consistent with the normal theory of pur-

> chased annuities, and seems to us to be fairer than to regard the first payments as wholly tax free and the latter payments as wholly taxable. The theory of apportionment is applicable to periodic payments just as it is to the ascertainment of gain in the sale of lots in a subdivided tract of land, of retail goods purchased in bulk, and other situations under the statute.

That even where the payments clearly represent deferred installments of the purchase price there is an element of income present if the period of payment is extended over a term of years, has been recognized in several decisions. See *Ruth Iron Co.* v. *Commissioner of Internal Revenue* (C. C. A. 8th), 26 F. (2d) 30; *Kosmerl* v. *Commissioner of Internal Revenue* (C. C. A. 7th), 25 F. (2d) 87; *Platt* v. *Bowers* (S. D. N. Y.), 13 F. (2d) 951.

In *Rosenberger* v. *McCaughn* (C. C. A. 3d), 25 F. (2d) 699, certiorari denied, 278 U. S. 604, an owner of land demised to a coal company all coal under the land with the right to mine it for a term of 99 years, in consideration of monthly rents reckoned on the coal raised and the price realized. In holding that it was proper to allocate part of the annual payments to income, the court said (p. 701):

> Reverting to the plaintiff's contention that all payments she had received under the instrument here in question were tax free because they were part payments of the pur-

> chase price of property sold prior to March 1, 1913, still—always keeping in view the nature of mining, the source of the proceeds—we think each payment represented in some measure both capital and increment, capital because it stood in the place of coal and increment because in the payments running through ninety-nine years interest on the capital must inevitably have been included, and that this increment or interest was a gain "derived" within the generalization of the statute "from any source whatever" and was income in substantially the sense of *New Creek Co.* v. *Lederer* (C. C. A.), 295 F. 433.

The requirement that capital must all be returned tax free before there is any taxable income is limited to cases of sales, as in *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179. The rule that annual receipts which represent the earnings of property are wholly taxable except in so far as Congress grants allowances has already been stated.

This fundamental difference in the treatment of the proceeds of sales of capital assets and the annual receipts from the operation of a business is due to the fact that Congress may tax only the profit on sales of capital assets, whereas in the case of annual receipts, which are inherently income by nature, it is competent for Congress to treat them as wholly taxable. Because property often increases in value even where its physical life is theoretically wasting away, there can be no cer-

tainty that any of the capital value has disappeared until a final disposition of the property is made. Accordingly, this Court sustained an arbitrary depletion allowance in the case of operating mines against the contention that it was wholly inadequate and that consequently the tax was upon property because of its ownership. *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103.

In the brief in opposition (pp. 4–5) respondents cite *Nichols* v. *United States*, 64 C. Cls. 241, certiorari denied, 277 U. S. 584, as presenting practically the same question as the instant cases. The question in that case was whether the distributive share of a partner received by his estate after his death and upon which an estate tax had been paid was also income to the estate upon which an income tax, too, should be paid. The Government contended that it was inherently income, would have been taxable to the decedent if he had received it during his lifetime, and that consequently it should be regarded as income to the estate. The Court of Claims held that when the distributive share was paid to the estate it was corpus and not income, and, having been taxed as part of the estate, could not be again taxed as income to the estate. It is evident that this does not touch the problem here. The Government does not claim a right to tax the capital of the respondents nor, so far as the interests acquired by the respondents by bequest are concerned, does it propose to tax the estate from

which such interests came as if such interests were income to the estate. The Government merely asserts the right to tax such portion of the sums received by the respondents due to the Youngstown Company's performance of its contract, as represents profit or increment and to tax it as that profit or increment is received and not at some indefinite future date.

CONCLUSION

In view of the foregoing it is respectfully submitted that the judgments of the Circuit Court of Appeals should be reversed.

THOMAS D. THATCHER,
Solicitor General.
G. A. YOUNGQUIST,
Assistant Attorney General.
SEWALL KEY,
J. LOUIS MONARCH,
Special Assistants to the Attorney General.
WHITNEY NORTH SEYMOUR,
Attorney.

APRIL, 1931.

APPENDIX A

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1060, 1062, 1064, 1065, 1066, 1067:

> SEC. 202. (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—
>
> (1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and
>
> (2) In the case of property acquired on or after that date, the cost thereof; * * *.
>
> (b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; * * *.
>
> SEC. 210. * * * there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax * * *.
>
> SEC. 211. (a) * * * in addition to the normal tax imposed by section 210 of this Act, there shall be levied, collected, and paid for each taxable year upon the net income of every individual, a surtax * * *.
>
> SEC. 212. (a) That in the case of an individual the term "net income" means the

gross income as defined in section 213, less the deductions allowed by section 214.

* * * * *

SEC. 213. That for the purposes of this title * * * the term "gross income"—

(a) Includes gains, profits, and income derived from * * * dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; * * *.

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

* * * * *

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

* * * * *

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar condition in each case, based upon cost including cost of development not otherwise deducted: * * *.

Regulations 45 (1920 ed. as amended by T. D. 3206) relative to the Revenue Act of 1918:

ART 201. *Depletion of mines, oil and gas wells; depreciation of improvements.*—Sections 214 (a) (10) and 234 (a) (9) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. * * *

The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (a) his capital invested in the property or (b) the value of his property on the basic date, plus subsequent allowable capital additions * * *.

* * * * *

When used in these articles of the regulations covering depletion and depreciation—

(a) The term "basic date" indicates the date of valuation, i. e., March 1, 1913, in the case of property acquired prior thereto, the date of acquisition in the case of property acquired on or after March 1, 1913, or the date of discovery, or within 30 days thereafter, in the case of discovery.

(b) The "fair market value" of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase. Where there has been no sale and the fair market value at the basic date is to be used, such value will be determined by the method which a prospective vendor and vendee in the industry would use in arriving

at the sale value of the property at the basic date.

* * * * *

ART. 206. *Determination of fair market value of mineral property.*—(a) Where the fair market value of the property at a specified date in lieu of the cost thereof is the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner, by the owner of the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or subsequent improvements in methods of extraction and treatment of the mineral product. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The Commissioner will lend due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purpose of the capital-stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, disinterested appraisals by approved methods such as the present value method and other factors.

(b) To determine the fair market value of a mineral property by the present value method, the essential factors must be determined for each deposit included in the property. The factors are (1) the total quantity

of mineral in terms of the principal or customary unit (or units) paid for in the product marketed, (2) the average quality or grade of the mineral reserves, (3) the expected percentage of extraction or recovery in each process or operation necessary for the preparation of the crude mineral for market, (4) the probable operating life of the deposit in years, (5) the unit operating cost, i. e., cost of production exclusive of depreciation and depletion, (6) expected average selling price per unit during the operating life, and (7) the rate of profit commensurate with the risk for the particular deposit. When the deposit has been sufficiently developed these factors may be determined from past operating experience. In the application of factors derived from past experience full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recovery, costs of production, and selling price of the product marketed during the expected operating life of the mineral deposit.

* * * * * *

ART. 210. *Computation of deduction for depletion of mineral deposits.*—(a) Depletion attaches to the annual production "according to the peculiar conditions of each case" * * *.

(b) When the value of the property at the basic date has been determined, depletion for the taxable year shall be determined by dividing the value remaining for depletion by the number of units of mineral to which this value is applicable, and by multiplying the unit value for depletion, so determined, by the number of units sold within the taxable year. In the selection of a unit for

depletion preference shall be given to the principal or customary unit or units paid for in the product sold.

ART. 1564. *Determination of gain or loss from exchange of property.*—(a) The amount of income derived from an exchange of property, as of stock for a bond, is the excess of the fair market value at the time of exchange of the property received in exchange over the original cost of the property exchanged for it. If the property exchanged was acquired prior to March 1, 1913, and its fair market value on that date was greater than the cost, the income which is taxable is the excess of the fair market value at the time of exchange of the property received in exchange over the fair market value on March 1, 1913, of the property exchanged. No gain is recognized if the fair market value of the property received in exchange is more than the cost of the property exchanged but less than its fair market value as of March 1, 1913. The amount of income derived from a subsequent sale for cash of property received in exchange for other property on or after March 1, 1913, is the excess of the amount so received over the fair market value of the property acquired at the date of the acquisition. * * *

APPENDIX B

Nos. 5552–3–4

UNITED STATES CIRCUIT COURT OF APPEALS, SIXTH CIRCUIT

CARRIE L. SHAW, EXECUTRIX, ETC.

v.

COMMISSIONER OF INTERNAL REVENUE

ORDER

Before MOORMAN, HICKS, and HICKENLOOPER, Circuit Judges

The orders of the Board of Tax Appeals in these cases are affirmed on authority of *Frank Hitchcock* v. *Commissioner of Internal Revenue,* No. 5550, this day decided.

U. S. GOVERNMENT PRINTING OFFICE: 1931